SENATE FISCAL AGENCY
ISSUE PAPER

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

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June 2001

A Series of Papers Examining Critical Issues Facing the Michigan Legislature

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ACKNOWLEDGMENTS

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INTRODUCTION

The recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 represents the largest tax cut granted by the Federal government since 1981. The overall tax cuts are centered primarily around the individual income tax and estate tax, but also include some provisions that will benefit businesses. The major highlights of this Act include:

- The marginal tax rates of the individual income tax are reduced, plus a new tax bracket with a 10% tax rate is added.

- A tax rebate, which will equal the tax cut resulting from the new 10% tax bracket, will be paid to taxpayers in the summer of 2001.

- The estate tax will be gradually reduced beginning in 2002 and will be completely eliminated in 2010.

- The enacted tax cuts will reduce Federal government revenue a total of $1.35 trillion from fiscal year (FY) 2000-01 to FY 2010-11.

- Almost 60% of the tax cuts will not be realized until the period from 2007 to 2011.

- All of the tax cuts enacted in this Act will expire at the end of 2010 and then will revert to the levels in place before this Act was enacted.

In addition, the Federal tax changes will also affect the revenue generated from Michigan's individual income tax, estate tax, and single business tax. In general, the base of these Michigan taxes is tied to various Federal definitions, measures of income, and credits, some of which are changed under the new Federal tax law. As a result, Michigan's revenue from these taxes will decline an estimated $34 million in FY 2001-02, $120 million in FY 2002-03, and $179 million in FY 2003-04. This report provides a summary of the Economic Growth and Tax Relief Reconciliation Act of 2001, including descriptions of the major tax cuts and a breakdown of their fiscal impacts. This report also explains of these Federal tax changes will affect Michigan's income, estate, and single business taxes, as well as providing estimates of those impacts.

FISCAL IMPACT ON U.S. TAXPAYERS

The Economic Growth and Tax Relief Reconciliation Act of 2001 will reduce the amount of taxes that taxpayers will pay from 2001 to 2011. During these 11 years, it is estimated that Federal tax collections will be reduced by $1.35 trillion from what they otherwise would have been. Table 1 summarizes the estimated tax reductions that will occur over each of these 11 years for each of the major tax cut categories.

Major Tax Reductions

Most of the cut in taxes will occur in three major areas, as shown in Figure 1. The reduction in the marginal tax rates is by far the largest component of the overall cut in taxes, as its revenue impact accounts for 62% of the total tax reductions during this 11-year period. The next two largest tax reductions result from the increase in the child tax credit and the phased repeal of the estate tax, which account for 13% and 10%, respectively, of the total amount being cut from Federal taxes.

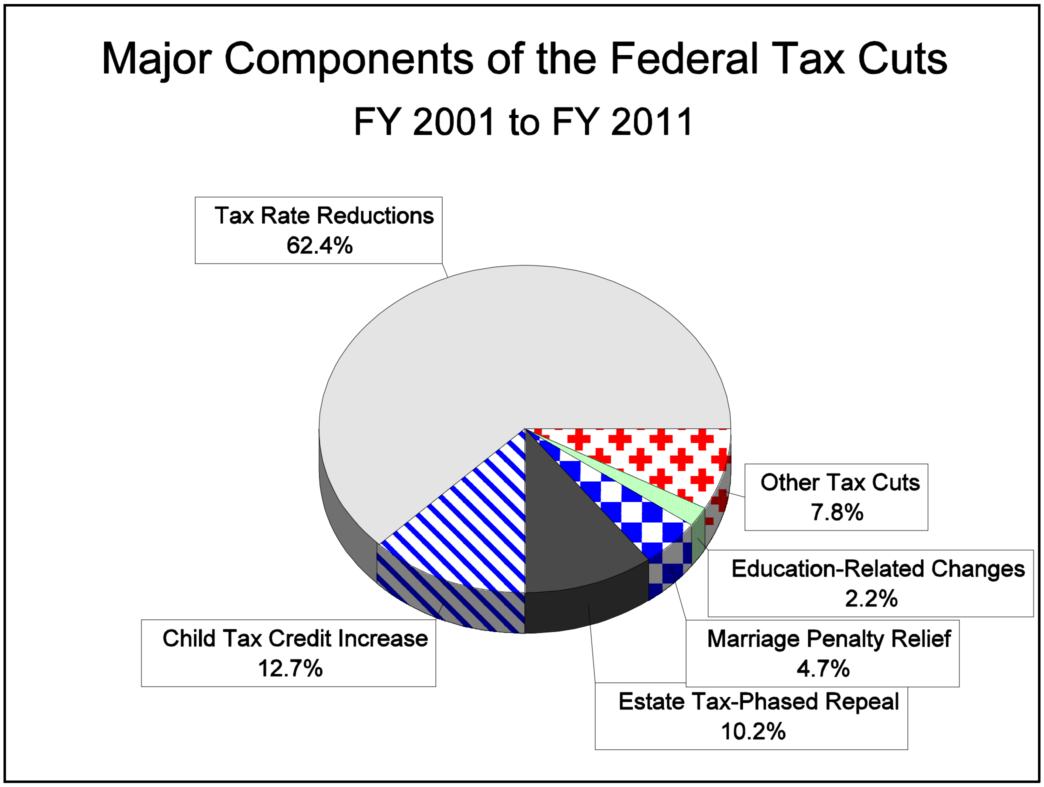
Table 1

SUMMARY OF TAX CUTS U.S. TAXPAYERS WILL RECEIVE UNDER THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001
(billions of dollars)

Provision	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total 2001-2011
Tax Rate Reductions:												
New 10% tax bracket	($38.2)	($33.4)	($40.2)	($40.3)	($40.2)	($40.2)	($40.1)	($43.4)	($45.4)	($46.0)	($13.9)	($421.3)
Tax Rate Phased Reductions	(2.0)	(21.1)	(21.3)	(29.0)	(32.8)	(50.9)	(59.4)	(60.4)	(61.7)	(63.0)	(19.0)	(420.6)
Subtotal Tax Rate Reductions	**(40.2)**	**(54.5)**	**(61.5)**	**(69.4)**	**(73.0)**	**(91.1)**	**(99.4)**	**(103.8)**	**(107.0)**	**(109.1)**	**(32.9)**	**(841.9)**
Phased Repeal of Personal Exemption Phase-Out	—	—	—	—	—	(1.3)	(2.6)	(4.0)	(5.4)	(7.2)	(4.5)	(24.9)
Phased Repeal of Itemized Deduction Phase-Out	—	—	—	—	—	(0.5)	(1.0)	(1.4)	(1.8)	(2.2)	(1.3)	(8.1)
Child Tax Credit Increase	(0.5)	(9.3)	(9.9)	(10.6)	(12.8)	(18.3)	(19.0)	(19.4)	(20.5)	(25.2)	(26.2)	(171.8)
Dependent Care Tax Credit Increase	—	—	(0.3)	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(0.3)	(0.3)	(0.1)	(3.0)
Adoption Credit Increase	—	(0.1)	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.4)	(0.4)	(0.4)	(0.5)	(3.1)
Marriage Penalty Relief	—	(0.0)	(0.8)	(1.3)	(6.1)	(10.0)	(11.0)	(10.4)	(10.2)	(9.2)	(4.3)	(63.3)
Education-Related Changes:												
Education IRAs-Increase In Contribution Limit	—	(0.2)	(0.4)	(0.5)	(0.6)	(0.7)	(0.8)	(0.9)	(1.0)	(1.1)	(0.3)	(6.4)
Prepaid Tuition Plan Changes	—	(0.0)	(0.1)	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)	(0.2)	(0.3)	(0.1)	(1.3)
Student Loan Interest Deduction Increase	—	(0.2)	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.4)	(0.1)	(2.7)
New Higher Ed. Expense Deduction	—	(1.5)	(2.1)	(2.7)	(2.9)	(0.7)	0.0	0.0	0.0	0.0	0.0	(9.9)
Employer-Provided Assistance Changes	—	(0.5)	(0.7)	(0.8)	(0.8)	(0.9)	(0.9)	(1.0)	(1.0)	(1.1)	(0.3)	(7.9)
Other Education-Related Changes	—	(0.0)	(0.0)	(0.0)	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)	(0.2)	(0.3)	(1.3)
Subtotal Education-Related Changes	**—**	**(2.5)**	**(3.5)**	**(4.3)**	**(4.7)**	**(2.8)**	**(2.3)**	**(2.5)**	**(2.8)**	**(3.1)**	**(1.0)**	**(29.4)**
Alternative Minimum Tax Reduction	(0.2)	(2.3)	(3.2)	(4.6)	(3.6)	—	—	—	—	—	—	(13.9)
Estate Tax - Phased Repeal	—	(0.1)	(7.0)	(5.6)	(7.6)	(4.6)	(10.2)	(12.4)	(13.2)	(23.5)	(53.9)	(138.0)
Individual Retirement Arrangement Changes	—	(0.4)	(1.0)	(1.2)	(1.9)	(2.6)	(2.9)	(3.4)	(4.0)	(4.5)	(3.2)	(25.1)
Pension Tax Changes	—	(1.5)	(3.1)	(3.3)	(3.4)	(3.2)	(2.5)	(1.8)	(2.0)	(2.2)	(1.6)	(24.5)
Other Tax Changes	(32.9)	32.9	(0.1)	(6.7)	6.5	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(0.1)	(1.4)
TOTAL	**($73.8)**	**($37.8)**	**($90.6)**	**($107.7)**	**($107.4)**	**($135.2)**	**($151.7)**	**($160.1)**	**($167.8)**	**($187.0)**	**($129.5)**	**($1,348.6)**

Source: Compiled by the Senate Fiscal Agency based on estimates from the Congressional Joint Committee on Taxation.

Figure 1



Timing of Tax Cuts

Another key feature of this tax-reduction Act is that not all of the tax cuts become effective at the same time. The different tax reductions have a variety of effective dates, ending dates, and phase-in schedules. The reductions in the income tax marginal rates begin in 2001, but are not fully phased in until 2006. Similarly, a series of phased-in reductions is scheduled for the estate tax beginning in 2002, which will lead to its complete elimination in 2010. Other tax reductions have much different timing. For example, the new deduction for higher education expenses takes effect in 2002, is increased in 2004, but then is repealed in 2006. The phased-in elimination of the current phase-out of itemized deductions and personal exemptions, which applies to taxpayers above a certain income threshold, does not begin until 2006. The various beginning, ending, and phase-in periods are illustrated in Figure 2.

Timing of the Revenue Impacts

Due to the timing of the tax cuts, they actually will have a larger fiscal impact in the latter years of this 11-year period, compared with the initial years. As illustrated in Figure 3, of the total value of the tax cuts, 41% will be cut from 2001 to 2006 and 59% will be cut from 2007 to 2011. This "back-loading" of the tax cuts is particularly true for the estate tax, for which only 18% of the total 11-year cut will be realized from 2001 to 2006 and 82% will occur from 2007 to 2011.

Figure 2

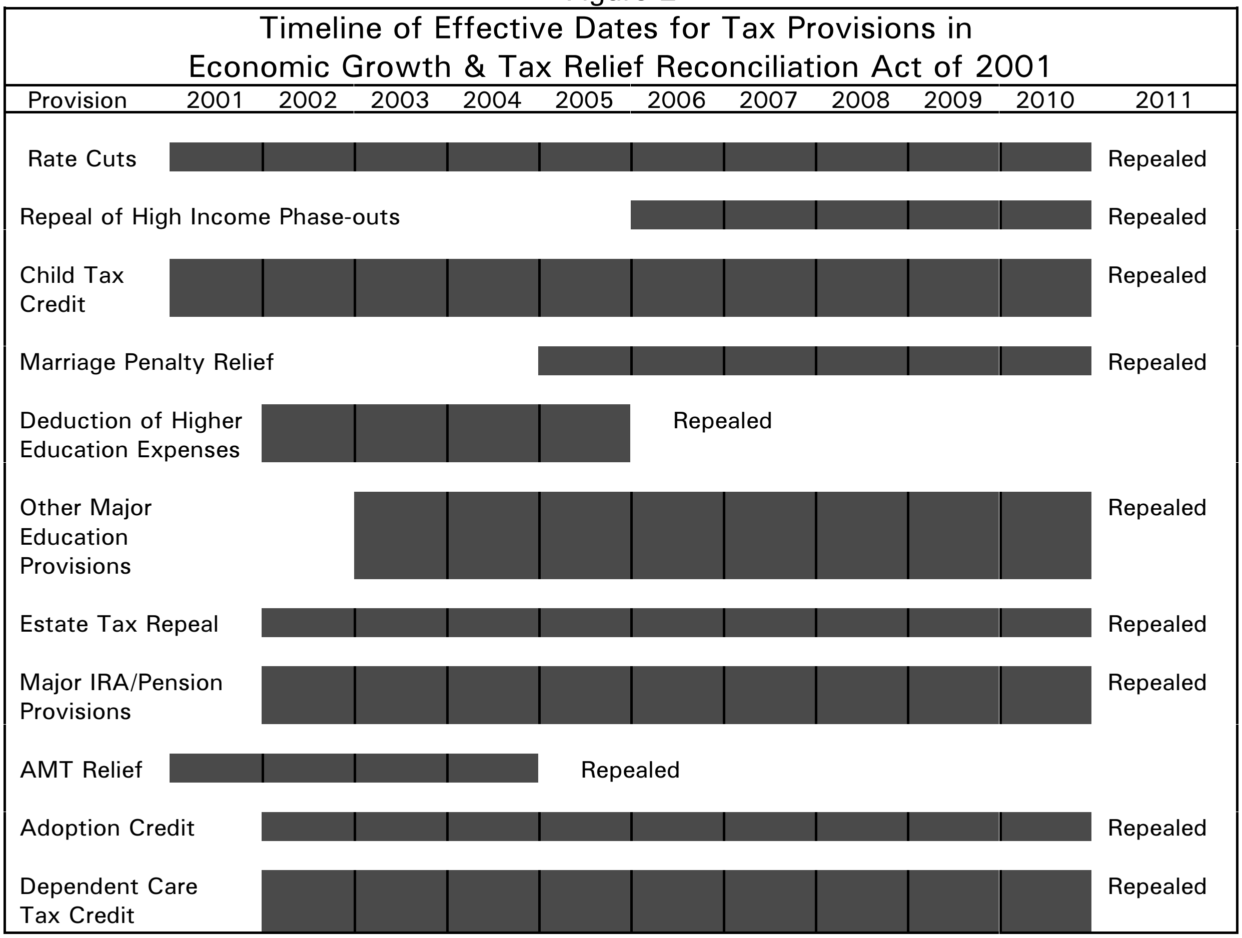
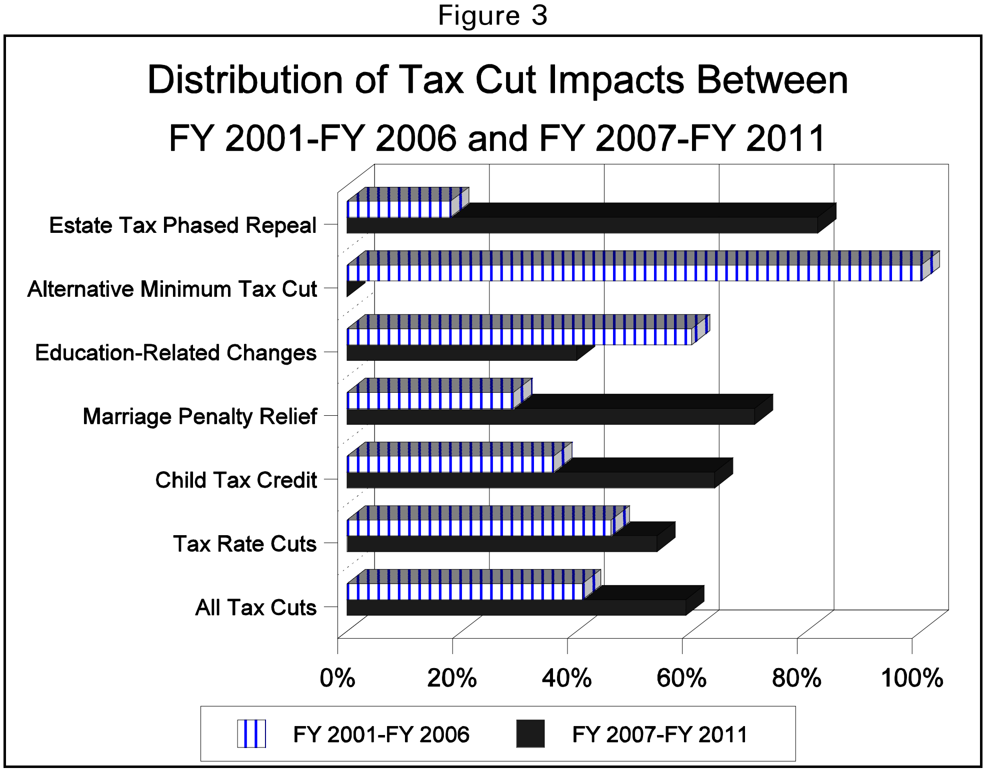


Figure 3



INDIVIDUAL INCOME TAX CHANGES

Most of the tax reductions included in the Economic Growth and Tax Relief Reconciliation of 2001 Act, are in the individual income tax. The major enacted changes to the individual income tax are summarized below. However, as with all of the changes in the Act, all of these changes are repealed for tax years beginning after December 31, 2010. In addition, a description of the basic structure and key components of the Federal income tax is presented in Appendix A.

<u>Tax Rate Reduction</u>

One of the key features of the 2001 tax reduction Act is the reduction in the tax rates for the individual income tax. Under the old law, the Federal individual income tax included five tax brackets with progressively higher marginal tax rates equal to 15%, 28%, 31%, 36%, and 39.6%. The income levels at which these tax rates apply dependent on whether the taxpayer is single, head of household, married filing a joint return, or married filing a separate return. For a married couple filing a joint return, the income tax brackets were as follows for tax year 2000: 15% for the first $43,850 of taxable income; 28% for every dollar of taxable income in excess of $43,850 up to $105,950; 31% for taxable income from $105,950 - $161,450; 36% for taxable income from $161,451 - $288,350; and 39.6% for taxable income in excess of $288,350. The enacted changes to these marginal tax rates include the addition of a new 10% tax bracket, adjustment of the 15% tax bracket, and a reduction in the marginal rates that apply to the four highest tax brackets.

New 10% Tax Bracket. A new 10% tax bracket has been created. This new tax bracket applies to taxable income that was previously included in the 15% tax bracket and takes effect retroactively to January 1, 2001. The taxable income levels for the 10% tax bracket, for each type of taxpayer, are presented in <u>Table 2</u>. These taxable income levels will not be adjusted for inflation each year, as they are in the other tax brackets.

Table 2

NEW 10% INCOME TAX BRACKET

	Taxable Income Subject to New 10% Tax Rate		
Tax Years	Singles and Married Filing Separately	Heads of Households	Married Couples Filing Jointly
2001-2007	$1 - $6,000	$1 - $10,000	$1 - $12,000
2008-2010	$1 - $7,000	$1 - $10,000	$1 - $14,000
2011 and after	0	0	0

Source: The Federal Economic Growth and Tax Relief Reconciliation Act of 2001.

15% Tax Bracket Adjustment. The 15% tax bracket will begin where the new 10% tax bracket ends and will end at the same level as it would under prior law with one exception. The 15% tax bracket is being expanded for taxpayers who are married filing a joint return to help reduce the marriage penalty. (See Marriage Penalty Relief, below.)

Other Tax Rate Reductions. The current marginal tax rates of 28%, 31%, 36%, and 39.6%, will be gradually reduced beginning July 1, 2001, until they reach 25%, 28%, 33%, and

35%, respectively, on January 1, 2006. The taxable income levels for each of these tax brackets will continue to be indexed to inflation each year and are not changed by this Act. The phased-in reductions in each of these marginal tax rates are presented in Table 3 and Appendix B.

Table 3

INDIVIDUAL INCOME TAX MARGINAL TAX RATE REDUCTIONS				
Tax Years	Marginal Tax Rates			
Old Law:				
2000[1)]	28.0%	31.0%	36.0%	39.6%
New Law:				
2001	27.5%	30.5%	35.5%	39.1%
2002-2003	27.0%	30.0%	35.0%	38.6%
2004-2005	26.0%	29.0%	34.0%	37.6%
2006-2010	25.0%	28.0%	33.0%	35.0%
2011 and after	28.0%	31.0%	36.0%	39.6%

1) The tax rates for 2001 are the averages of the old rates, which will be in effect until June 30, 2001, and the new rates, which become effective July 1, 2001.

Source: The Federal Economic Growth and Tax Relief Reconciliation Act of 2001.

Tax Rate Reduction Credit in 2001

The Act also includes a tax rate reduction credit that will be in effect only in 2001. This credit will implement the tax reduction that taxpayers will realize due to the new 10% tax bracket, so this credit is in lieu of the 10% tax bracket in 2001. The tax credit will be equal to 5% of the income that previously was taxed at 15%, but will now be taxed at the new rate of 10%. As shown in Table 2, a single person will be subject to the 10% tax rate on his or her first $6,000 of taxable income, so the person's credit will equal 5% (old tax rate of 15% minus new tax rate of 10%) of his or her taxable income up to a maximum of $6,000, for a maximum credit of $300. The maximum credit for heads of households will be $500 and married couples filing jointly will receive a credit of up to $600.

The U.S. Department of Treasury will calculate and rebate these credits to eligible taxpayers. These tax rebate checks will be mailed to taxpayers between late July and the end of September 2001. While these payments represent credits against a taxpayer's 2001 tax liability, the credits will be calculated for all taxpayers who filed a return in 2000 and will be based on the taxable income and filing status reported on their 2000 tax return. Taxpayers then will recalculate their credit when filing their 2001 tax return using their 2001 taxable income and filing status. For most taxpayers the recalculated credit will not be different from the rebated credit; however, if a taxpayer's recalculated credit is greater than his or her rebated credit, the taxpayer will be able to claim the difference as an additional tax credit on his or her 2001 return. If the recalculated credit is less than the rebated credit, the difference will not have to be repaid.

Marriage Penalty Relief

Under the Federal individual income tax, many married couples who both earn income effectively pay a "marriage tax penalty". This "marriage penalty" results from the progressive rate schedule, under which the combined income of the married couple is taxed at a higher rate, and therefore results in a higher tax liability than would occur if the individuals were not married and filed single returns. To help reduce the "marriage penalty", the Act makes the following changes:

- Increases the Standard Deduction for Married Couples - Beginning in 2005, the standard deduction for married couples filing jointly will be increased. Currently, the standard deduction for married couples filing jointly is 67% larger than the standard deduction for a single person. This differential will continue through 2004 and then beginning in 2005, the standard deduction for married couples filing jointly will be gradually increased as a percentage of the standard deduction for single taxpayers until it reaches twice the standard deduction for single taxpayers in 2009. The phased-in increase in the standard deduction for married couples filing jointly, as a percentage of the standard deduction for single taxpayers, is presented in Table 4.

Table 4

INCREASE IN STANDARD DEDUCTION
FOR MARRIED COUPLES FILING JOINT RETURNS

Calendar Year	Standard Deduction for Joint Returns as a % of Standard Deduction for Singles
2001-2004	167%
2005	174%
2006	184%
2007	187%
2008	190%
2009-2010	200%
2001 and after	167%

Source: The Federal Economic Growth and Tax Relief Reconciliation Act of 2001.

- Expands the 15% Tax Rate Bracket - Beginning in 2005, the upper income limit of the 15% tax rate bracket for married couples filing a joint return will be gradually increased until 2008, when it reaches twice the upper income limit of the 15% tax rate bracket for single taxpayers.

- Changes the Earned Income Credit (EIC) - The Act also helps reduce the marriage penalty by increasing the beginning and ending points of the phase-out range for the EIC for married couples filing a joint return. This range is increased by $1,000 in 2002-2004, by $2,000 in 2005-2007, and by $3,000 in 2008 -2010.

Earned Income Credit

In addition, the new law makes several changes to simplify the EIC. These changes include repealing the provision that reduced the credit by a taxpayer's alternative minimum tax and changing the base for the EIC from modified adjusted gross income (AGI) to regular AGI.

Child Tax Credit

In 2000, the child tax credit was $500 per child. The Act gradually increases the child tax credit beginning in 2001 until it reaches $1,000 in 2010. The scheduled increases in the child credit are presented in Table 5.

Table 5

CHILD TAX CREDIT INCREASE	
Calendar Year	Credit Per Child
Old Law:	
2000	$500
New Law:	
2001-2004	$600
2005-2008	$700
2009	$800
2010	$1,000
2011 and after	$500
Source: The Federal Economic Growth and Tax Relief Reconciliation Act of 2001.	

Adoption Tax Credit

The adoption tax credit for all but special needs children was due to expire in 2002, but the Act extends it through 2010. In addition, the adoption credit is increased to $10,000 of eligible adoption expenses, from the previous level of $5,000 ($6,000 for special needs children), effective January 1, 2002.

Dependent Care Credit

The Act increases the dependent care tax credit in three ways. First, the maximum amount of employment-related dependent care expenses on which the credit is calculated is increased from $2,400 to $3,000 for taxpayers with one qualifying individual and from $4,800 to $6,000 for taxpayers with two or more qualifying individuals. Second, the maximum credit is increased from 30% to 40% of eligible expenses. As a result, the maximum credit is increased from $720 to $1,200 for one qualifying individual and from $1,440 to $2,400 for two or more qualifying individuals. Third, the credit percentage will continue to be phased down to 20%, as under current law, but the AGI level at which the phase-down begins is increased from $10,000 to $15,000, and the 20% credit will now become effective at AGI over $43,000, compared with over $28,000 under the old law. These changes will become effective January 1, 2003.

Phase-Out of Itemized Deductions and Personal Exemptions

Currently, the value of itemized deductions and personal exemptions claimed by taxpayers are phased out when their AGI exceeds certain levels. Under the Act, both of these phase-outs are reduced by one-third in 2006 and 2007, and by two-thirds in 2008 and 2009, and are fully eliminated in 2010.

Education-Related Income Tax Changes

The new Federal tax law modifies individual retirement accounts (IRAs) for education, private prepaid tuition programs, and deduction of interest on student loans. The law also creates a new deduction for qualified higher education expenses. The various education tax incentives will reduce Federal tax revenue an estimated $2.5 billion in 2002 and $3.5 billion in 2003, and from 2002 through 2011 will total an estimated $29 billion. As with the other income tax provisions, all education tax incentives not already terminated are repealed for tax years beginning after December 31, 2010.

Education IRAs. Federal law does not limit how many education IRAs a taxpayer may contribute to in a given year. However, total contributions, from all individuals, to all education IRAs for a specific beneficiary may not exceed a certain amount per year. Contributions to education IRAs are taxed but the interest earnings grow tax-free until withdrawn, when they are taxed at the beneficiary's level. The new law increases the contribution limit from $500 per beneficiary per year to $2,000. In addition, the ability of taxpayers to contribute to an education IRA is phased out at certain income levels. Under the old law, this phase-out occurred from $150,000 to $160,000 for married couples filing joint returns, but under the new law the phase-out occurs from $190,000 to $220,000. Single taxpayers face a phase-out range half that for married couples. Also, the new law expands the definition of qualified education expenses that may be withdrawn tax-free from an education IRA to include elementary and secondary school expenses. In addition, taxpayers now may claim a tax-free withdrawal from an education IRA in the same tax year that they claim a HOPE or Lifetime Learning credit, as long as the credit and education IRA are covering different expenses.

Qualified State Tuition Programs. The Federal income tax provides tax-deferred status to "qualified state tuition programs", which are certain programs established by a state in which a person may: 1) purchase tuition credits that entitle him or her to a waiver or payment of qualified higher education expenses, or 2) make a contribution to an account that is established for the purpose of meeting qualified higher education expenses. The new law redefines the "qualified tuition program" to include certain prepaid tuition programs established by one or more eligible educational institutions, one of which may be a private institution. If the qualified tuition program is private, taxpayers may be able to purchase tuition credits and receive a waiver, but cannot make contributions to a savings account plan. Furthermore, distributions from qualified tuition programs may be excluded from gross income to the extent that the distributions are used to pay for certain higher education expenses. In addition, a taxpayer may claim a HOPE credit or Lifetime Learning credit and may exclude from his or her gross income amounts distributed from a tuition program as long as the credit and the tuition program payments are for different expenses.

Student Loan Interest Deduction. A taxpayer may claim a deduction for the interest paid on student loans, as long as the taxpayer's income is below a particular level. Under the old law, this deduction could not exceed $2,500 per year, and could be claimed only on the interest paid during the first 60 months of the loan repayment. The new law does not change the $2,500 maximum deduction per year, but it does eliminate the 60-month limit. In addition, the new law increases the income phase-out range from $40,000 - $55,000 to $50,000 - $65,000 for single taxpayers and from $60,000 - $75,000 to $100,000 - $130,000 for married couples filing a joint return.

Deduction for Qualified Higher Education Expenses. For tax years 2002-2005, the law creates a new deduction for "qualified higher education expenses". A "qualified higher education expense" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the student at a higher education institution. Within limits, these expenses also may include room and board for any academic period during which the student is enrolled at least half-time. In 2002 and 2003, taxpayers with an AGI that does not exceed $65,000 for single taxpayers and $130,000 for married taxpayers are entitled to a maximum tax deduction of $3,000 per year for a qualified higher education expense. In 2004 and 2005, taxpayers who fall below this ceiling may deduct a maximum of $4,000, and taxpayers whose AGI does not exceed $80,000 for single and $160,000 for married may take a deduction of $2,000. This deduction expires in 2006.

<u>Individual Retirement Arrangements and Pension-Related Tax Changes</u>

The Economic Growth and Tax Relief Reconciliation Act of 2001 also makes numerous changes to both individual retirement account rules and rules regarding other retirement plans. The changes affect both employees and employers. The provisions regarding employees generally concern increasing the amount of money taxpayers may put into retirement and pension funds, while the provisions regarding employers generally involve decreasing the cost of retirement plans and pension funds. The IRA and pension provisions will mainly alter individual income tax revenues. However, those changes that affect employers will change either corporate or individual income tax receipts, depending on whether or not the employer is incorporated. Furthermore, as with the tax rate changes and education tax incentives, all IRA and pensions provisions are repealed for tax years beginning after December 31, 2010.

Individual Retirement Accounts. Under the prior law, individuals could deduct up to $2,000 per year for contributions to an individual retirement account. The IRA-contribution limit was not adjusted annually for inflation, and as a result, the $2,000 limit had been in place since it was expanded from $1,500 per year in 1981. Under the new law, the maximum amount that may be deducted is increased to $3,000 in tax years beginning in 2002 through 2004, to $4,000 in tax years beginning in 2005 through 2007, and to $5,000 in tax years beginning in 2008. After 2008, the maximum deduction amount will be indexed for inflation, increasing by $500 increments. For individuals age 50 and above, the maximum contribution limits are increased by $500 per year for tax years beginning in 2002 through 2005 and then by $1,000 per year for tax years beginning in 2006 and later. The prior law did not provide a higher maximum for individuals age 50 and above.

Limits on Deferred Compensation and other Elective Deferrals. When an employee chooses to have his or her employer make contributions, usually in lieu of wages, to certain retirement plans, such contributions are termed elective deferrals. Several types of retirement plans may receive elective deferrals and the type of plan determines the limit on how much compensation an employee may defer to the plan. The new law increases the limits for several types of plans. Currently, a qualified cash or deferred arrangement (section 401(k) plan), a tax-sheltered annuity (section 403(b) annuity), or a salary reduction simplified employee pension plan (SEP), is limited to $10,500 in 2001. The new law increases the limit for these plans to $11,000 in 2002, and then raises the limit by $1,000 per year until it reaches $15,000 in 2006. In years after 2006, the contribution limit is adjusted for inflation. For retirement contributions to Savings Incentive Match Plans for Employees of Small Employers (SIMPLE), the limit is increased from $6,500 in 2001 to $7,000 in 2002. SIMPLE limits are then increased by $1,000 per year until they reach $10,000 in 2005. After 2005, SIMPLE limits are adjusted for inflation. Deferred compensation limits for state or local government or tax-exempt organization retirement plans (section 457 PLANS) are increased from $8,500 in 2001 to $11,000 in 2002. Limits for 457 plans are then increased by $1,000 per year until they reach $15,000 in 2006. After 2006, limits on 457 plans are adjusted for inflation. These maximum contribution levels are listed in Table 6.

Compensation Limits. Most retirement plans, especially those qualifying for certain tax benefits, face Federal restrictions on the compensation that may be included when contribution and/or benefit limits are calculated, particularly with regard to employer contributions that may be deducted. The new law increases the maximum compensation that may be included when benefit or contribution limits are calculated, and indexes most limits that current law does not index for inflation. Similarly, the Act reduces the types of compensation that must be included when compensation limits are calculated. The new law also makes a one-time increase in the maximum annual benefit, from $140,000 to $160,000, that may be paid by a qualified defined benefit plan. The prior law also placed additional limits on contributions to most tax-favored retirement plans, usually at 25% or 33 1/3% of compensation. Under the new law, those limits are increased to 100% of compensation.

Table 6

MAXIMUM CONTRIBUTION LEVELS FOR RETIREMENT ACCOUNTS: 2001 TO 2009

Retirement Account Type	2001 Level Under Current Law	2002	2003	2004	2005	2006	2007	2008	2009
IRA	$2,000	$3,000	$3,000	$3,000	$4,000	$4,000	$4,000	$5,000	Indexed
SIMPLE Plan	$6,500	$7,000	$8,000	$9,000	$10,000	Indexed			
457 Plan	$8,500	$11,000	$12,000	$13,000	$14,000	$15,000	Indexed		
401(k), 403(b), & SEP Plans	$10,500	$11,000	$12,000	$13,000	$14,000	$15,000	Indexed		

Source: The Federal Economic Growth and Tax Relief Reconciliation Act of 2001.

Retirement Plan Tax Credits. The new law creates two new credits for certain retirement plan activity. One credit is provided for expenses a small business incurs during the first three years after creating a new retirement plan. The other credit allows individuals, based on income and filing status, to claim a nonrefundable credit for a portion of elective deferrals to most retirement plans. For the lowest income individuals, the credit is equal to 50% of the contributions. As income rises, the percentage used to compute the credit declines. Single filers are ineligible for the credit once their income exceeds $25,000 and married couples filing jointly are ineligible once their income exceeds $50,000.

Retirement Age. Under the prior law, several provisions regarding retirement plans make reference to the Social Security retirement age. The new law alters many of these references to refer to a specific age, such as age 62 or age 65. Consequently, the tax rules for retirement accounts will not be altered by changes in the retirement age for Social Security purposes.

Rollovers and Retirement Plan Portability. The new law includes a number of changes to make it easier for employees to transfer retirement plan assets, benefits, and/or protections to a new employer or other tax-preferred investment when switching jobs. The most notable changes increase the number of plans in which rollovers may occur without a tax penalty. For instance, under the prior law, distributions from a section 457 plan could not be rolled over to another 457 plan, an IRA, or a qualified retirement plan. The new law allows section 457 distributions to be rolled over into any of these plans, provided the receiving plan will accept such a rollover.

Pension Security and Administration. The new law also contains a number of provisions to improve the funding of pension plans, to reduce the regulatory and administrative burdens of retirement plans, and to prevent certain conflicts-of-interest or financial problems that may occur in the administration of a retirement plan. The most notable change increases the minimum funding requirements for qualified retirement plans, with a corresponding increase in the employer contributions that may be deducted.

<u>Alternative Minimum Tax</u>

The alternative minimum tax (AMT) is designed to ensure that higher income taxpayers pay at least some minimum amount of income tax. It is a complicated feature of the income tax, but briefly, the AMT is imposed if it exceeds a taxpayer's regular income tax liability. The AMT, which has a broader measure of income than under the regular income tax, assesses a 26% tax rate on the first $175,000 of taxable income and 28% on any remaining income. Under previous law, taxable income was the amount of income that exceeded the exemption amounts of $45,000 for married individuals filing a joint return, $33,750 for single persons, and $22,500 for married people filing a separate return. The Act increases the exemption amounts, but only for tax years 2001 through 2004. The exemption levels are increased as follows: The exemption for married couples filing jointly will increase by $4,000 to $49,000; the exemption for single persons will increase by $2,000 to $33,750; and the exemption for married people filing separately will increase by $2,000 to $24,500. Beginning in 2005, the exemption levels will revert to the levels that were in place under the previous law.

ESTATE TAX CHANGES

The most drastic tax changes in the Economic Growth and Tax Relief Reconciliation Act of 2001 are made to the Federal estate tax. As part of a 10-year phase-out of the entire tax, the new law quickly phases out key credits. (See Estimated Impact on Michigan, below.) Ten years before the tax is repealed, the new law makes changes in every major feature of the Federal estate tax, including the tax rates, the tax base, all credits, and even how payments are made. Once the Federal estate tax is repealed, the new law changes the way assets are valued when transferred due to an asset owner's death. As with the other provisions in the new law, all changes to the Federal estate tax, including its elimination, are repealed for deaths occurring after December 31, 2010.

Rate Changes and Repeal

Under the prior law, estates with a taxable value of more than $2.5 million faced marginal tax rates of 53% to 55%, and estates with a taxable value of more than $10 million were subject to an additional 5% surtax on a portion of the estates. Beginning in 2002, those brackets with marginal tax rates in excess of 50% are combined and the rate is lowered to 50%. Furthermore, the 5% surtax is repealed. The highest marginal tax rate is then gradually decreased over the next eight years. In 2003, any estate tax rates in excess of 49% are repealed and the highest marginal rate falls by one percentage point per year until it reaches 45% in 2007. The highest marginal rate stays at 45% until 2010 when the entire estate tax is repealed.

Unified Credit

After estate taxes are calculated on the taxable portion of an estate, the estate receives a credit called the unified credit. The unified credit subtracts the tax liability for an estate of a given size, an amount traditionally regarded as an "exemption" from the tax in the popular press. Under the prior law, the size of the estate used to calculate the unified credit was scheduled to increase from $675,000 in 2001 to $1 million in 2006. The prior law also provided an additional credit for certain closely-held businesses and family farms, such that the total combined credit reflected an estate worth $1.3 million. The new law increases the estate size the unified credit is based upon to $1.0 million in 2002 and $1.5 million in 2004. Once the estate size is raised in 2004, the additional credit allowed for family farms and closely-held businesses will be repealed. The estate size the unified credit is based upon will increase to $2.0 million in 2006 and to $3.5 million in 2009. In 2010, the unified credit will be repealed, as is the estate tax.

State Death Tax Credit

The Federal estate tax allows taxpayers to claim a credit for any estate or inheritance tax paid to any state, subject to certain maximums. This "state death tax credit" is reduced under the new law. The state death tax credit is reduced by 25% in 2002, by 50% in 2003, and by 75% in 2004. Beginning in 2005, the state death tax credit will be repealed, although for Federal purposes it will be replaced by a deduction for the estate or inheritance taxes paid to any state.

Step-Up in Basis and Capital Gains

The basis of an asset generally represents a taxpayer's investment in property with certain adjustments required after acquisition. Basis generally increases by the cost of improvements made to the property and increases or decreases by any appreciation or depreciation in the property's value. Under the estate tax, the estate of a decedent includes the capital gain earned on the property when the estate's value is calculated. Consequently, the basis of property passing from a decedent's estate generally is "stepped up" to the fair market value on the date of the decedent's death. The value at the time the beneficiary acquires the property thus becomes the basis for the beneficiary. After the Federal estate tax is repealed in 2010, the step-up in basis for property acquired from a decedent will be repealed and new procedures will be implemented. The new procedures will use a modified carryover approach to determining basis. Generally, the new law does not provide a step-up in the basis of an asset, so if a beneficiary sells an inherited asset, the capital gains tax on the asset will be based upon the acquisition cost of the decedent rather than the beneficiary. However, the new law also provides that the basis may be stepped-up for a limited amount of property transferred at the time of death, in which case the basis for that property will equal the lesser of an adjusted basis or the fair market value of the property. The new law allows the basis of the estate to increase by up to a total of $1.3 million. Under the new Federal law, the basis of property transferred to a surviving spouse may be increased by an additional $3 million, raising the total basis increase for a spouse to $4.3 million. The limits on the increase in basis are adjusted annually for inflation after 2010. The changes in basis essentially place a capital gains tax on the inherited portion of assets that do not receive a step-up in basis.

Installment Payments

Under the prior law, certain estates were eligible to make installment payments on their Federal estate tax liability. Starting in 2002, the new law expands the types of estates that may elect to make installment payments.

SUNSET PROVISIONS

A very important feature of the Economic Growth and Tax Relief Reconciliation Act of 2001 is that all of the changes contained in this Act to the individual income, corporate income, and estate taxes, will expire for tax years beginning after December 31, 2010. This sunset was necessary to comply with rules that govern Congress' budget reconciliation process. One of these rules prohibits the consideration of legislation that would increase the deficit for a future fiscal year that is outside the scope of the budget reconciliation bill. The last year covered by the budget reconciliation measure is FY 2010-11, so sunsetting the various tax reductions contained in this Act after December 31, 2010, was necessary to assure that revenues would not be reduced from what they otherwise will be in FY 2011-12.

ESTIMATED IMPACT ON MICHIGAN

The newly enacted Federal tax cuts will affect Michigan taxpayers by changing both their Federal tax liabilities as well as their Michigan tax liabilities. The Federal tax changes will have an impact on a wide variety of Michigan taxes, including the individual income tax, estate tax, and single business tax.

Impact on Federal Taxes Paid by Michigan Taxpayers

The biggest change the new Federal law will make for Michigan taxpayers reflects the rate changes under the Federal individual income tax. Michigan taxpayers will pay approximately $1.5 billion less in Federal income taxes in FY 2000-01 and nearly $2.6 billion less in 2001-02. By FY 2009-10, Michigan taxpayers will pay approximately $6.6 billion less in Federal taxes than under the prior law. The majority of the tax reductions will come under the individual income tax. Individual income tax reductions account for more than 99% of the tax reduction in FY 2001-02, and the rate reductions account for 76.5% of the total tax reduction Michigan taxpayers will experience. In FY 1998-99, Michigan taxpayers paid approximately $63.7 billion in Federal individual income taxes.

Impact on Michigan Revenues

The Federal tax changes will affect the amount of revenue generated by several Michigan taxes, including the individual income tax, estate tax, and single business tax. Michigan taxes will be affected by the Federal changes in two respects:

- Federal changes that affect the Michigan tax base. These types of changes affect provisions under which Michigan bases a portion of the tax on some Federally defined concept. For example, the starting point for calculating the Michigan individual income tax is Federal adjusted gross income. Provisions in the new law that affect AGI thus will affect taxpayers' Michigan individual income tax liability. For example, the new Federal law reduces the income that must be included in AGI by exempting the income received from a qualified state tuition plan, which includes the Michigan Education Trust (MET).

- Federal changes that alter taxpayer behavior. Some of the tax changes in the new Federal law will encourage taxpayers to behave differently. Changes in behavior will occur as taxpayers adjust to take advantage of favorable tax provisions and/or avoid less preferable tax provisions. For example, the deduction for higher education expenses may encourage more individuals to go to college or to help finance someone else's college education.

Depending on the provision, the new Federal law may affect Michigan tax revenues through both mechanisms. For example, exempting MET payments from AGI also may encourage more people to purchase MET contracts for their children. Federal changes that do not affect the Michigan tax base or alter the taxable behavior of Michigan taxpayers, such as the reductions in the alternative minimum tax, will not affect Michigan revenues.

The two provisions of the Federal tax changes that will have the most significant impact on Michigan revenues are: 1) the phased-in repeal of the state death tax credit under the Federal estate tax, and 2) the new income deduction for higher education expenses. Together, these two provisions will account for 88.6% of the reduction in Michigan revenues attributable to the new Federal law over the FY 2001-02 to FY 2003-04 period. The impacts of these and the other key provisions that will affect Michigan tax revenue are described below.

As presented in Table 7, Michigan's tax revenue will decline by an estimated $34 million in FY 2001-02, $120 million in FY 2002-03, and $179 million in FY 2003-04, due to the Federal tax changes. Almost all of this loss in revenue will affect General Fund/General Purpose revenue.

Education Provisions

A number of education provisions in the new Federal law will reduce Michigan tax revenues under the individual income tax. The expansion of education IRAs will allow taxpayers to save a greater amount under the tax-deferred earnings provisions of education IRAs. As a result, taxpayers will receive less taxable interest and Federal AGI will be lowered. The expansion of the student loan interest deduction and the new deduction for higher education expenses will allow taxpayers to deduct expenses that were previously paid with taxable income. Because these deductions are not part of itemized deductions, but are part of the calculation of AGI, Michigan taxable income will be reduced. Finally, under the old law, the Federal government required most distributions from MET contracts to be included in gross income. Excluding such distributions will lower Federal AGI, thus reducing Michigan taxable income. The education provisions will lower Michigan individual income tax revenues by an estimated $12.9 million in FY 2001-02, $17.7 million in FY 2002-03, and $22.0 million in FY 2003-04.

Adoption Credit

Michigan allows a credit against the individual income tax for certain adoption expenses that exceed the Federal adoption credit. Expansion of the Federal adoption credit will reduce the expenses that may qualify for the Michigan adoption credit. As a result, fewer credits will be claimed under the Michigan tax, which will result in increased individual income tax revenues. Taxpayers still will receive the same total amount of Federal and state credits, since every dollar of increased Federal credits will be offset by a dollar decrease in the Michigan adoption credit. The changes in the adoption credit are expected to increase Michigan individual income tax revenues by $1.1 million each fiscal year over the FY 2001-02 to FY 2003-04 period.

Pensions and IRAs

A number of provisions in the new Federal law increase the amount of money taxpayers may contribute to tax-deductible retirement accounts or other tax-preferred retirement and pension plans. Many contributions to qualified IRAs and pension plans reduce the taxable wages taxpayers receive, while others are subtracted when AGI is calculated. Consequently, the new law will reduce Federal AGI and thus lower Michigan taxable income. The IRA and pension provisions are expected to reduce Michigan revenues under the individual income tax by $4.5 million in FY 2001-02, $9.9 million in FY 2002-03, and $12.5 million in FY 2003-04.

SBT Changes

Several provisions in the new law, particularly regarding pensions and other retirement plans, increase the deductions a business may claim. The single business tax (SBT) includes Federal taxable income in the computation of the SBT base. Consequently, the provisions in the new Federal law that increase deductions will lower Federal taxable income and thus reduce a portion of the SBT base. Single business tax revenues will decline by an estimated $0.5 million in FY 2001-02, $0.9 million in FY 2002-03, and $1.0 million in FY 2003-04 as a result of the increased Federal deductions.

Table 7

ESTIMATED IMPACT OF THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001
ON MICHIGAN REVENUES, BY FUND
(dollars in millions)

	FY 2001-02			FY 2002-03			FY 2003-04		
	General Fund/ General Purpose	School Aid Fund	Total	General Fund/ General Purpose	School Aid Fund	Total	General Fund/ General Purpose	School Aid Fund	Total
Income Tax:									
Education Provisions									
Education IRAs	($1.2)	$0.0	($1.2)	($2.1)	($0.1)	($2.1)	($2.5)	($0.1)	($2.5)
Student Loan Interest	($1.0)	$0.0	($1.0)	($1.3)	($0.0)	($1.4)	($1.4)	$0.0	($1.4)
Deduction for Higher Education Expenses	($10.2)	$0.0	($10.2)	($13.1)	($0.3)	($13.4)	($16.6)	($0.4)	($17.0)
MET Payments Exclusion	($0.5)	$0.0	($0.5)	($0.8)	$0.0	($0.8)	($1.0)	$0.0	($1.0)
Adoption Credit	$1.1	$0.0	$1.1	$1.1	$0.0	$1.1	$1.1	$0.0	$1.1
Pensions and IRAs									
IRA Provisions	($2.7)	$0.0	($2.7)	($5.8)	($0.2)	($6.0)	($7.0)	($0.2)	($7.2)
Expanding Coverage	($1.0)	$0.0	($1.0)	($2.4)	($0.1)	($2.5)	($3.6)	($0.1)	($3.7)
Enhancing Fairness for Women	($0.8)	$0.0	($0.8)	($1.5)	$0.0	($1.5)	($1.5)	$0.0	($1.5)
Subtotal: Income Tax Loss	($16.3)	$0.0	($16.3)	($25.9)	($0.7)	($26.5)	($32.5)	($0.9)	($33.4)
Single Business Tax Loss	($0.5)	$0.0	($0.5)	($0.9)	$0.0	($0.9)	($1.0)	$0.0	($1.0)
Estate Tax Loss	($17.0)	$0.0	($17.0)	($93.0)	$0.0	($93.0)	($145.0)	$0.0	($145.0)
Total Revenue Loss	**($33.8)**	**$0.0**	**($33.8)**	**($119.8)**	**($0.7)**	**($120.4)**	**($178.5)**	**($0.9)**	**($179.4)**

Source: Senate Fiscal Agency; Office of Revenue and Tax Analysis, Michigan Department of Treasury; and House Fiscal Agency

Estate Taxes

Michigan taxes the estates of decedents through a special type of estate tax referred to as a "pick-up" tax. The Federal estate tax allows estates a credit, up to a certain maximum, for any estate or inheritance taxes paid to state governments. Some states, including Michigan, levy an estate tax equal to the maximum state death tax credit allowed by the Federal government. Many states favor this approach because it allows them to collect revenue from decedents without increasing any estate's total tax burden. As a result of levying a tax equal to the state death tax credit, each dollar of revenue the state receives is one dollar the Federal government otherwise would receive. In order to reduce the fiscal impact of the other Federal estate tax changes in the early years, the new Federal law rapidly phases out the state death tax credit. The state death tax credit also will be reduced by the changes the Federal law makes in the tax rates and unified credit under the Federal estate tax. By FY 2004-05, the state death tax credit will be eliminated, effectively repealing the Michigan estate tax unless Michigan takes legislative action to replace or restructure the tax. Michigan currently collects slightly less than $200 million per year under the Michigan estate tax. Under the new Federal law, Michigan estate tax revenues will be reduced by an estimated $17.0 million in FY 2001-02, $93.0 million in FY 2002-03, and $145.0 million in FY 2003-04. By FY 2003-04, the reduction in Michigan estate tax revenues will account for 80.8% of the impact of the new Federal tax law on Michigan tax revenues.

CONCLUSION

The Economic Growth and Tax Relief Reconciliation Act of 2001 represents the largest tax cut enacted by the Federal government since 1981. The new law makes sweeping changes to the individual income tax and the estate tax. The changes in the law will affect Michigan residents by reducing their Federal tax liabilities and altering their liabilities under Michigan's individual income tax, estate tax, and single business tax.

APPENDIX A

FEDERAL INCOME TAX: BASIC STRUCTURE AND KEY TERMS

Basic Structure of the Federal Income Tax:
Adjusted Gross Income (AGI) - Includes income from such sources as wages, bonuses, earnings from investments, business income, alimony received, and unemployment compensation; less such expenses as contributions to IRAs, alimony payments, and job-related moving expenses.

Less: Standard Deduction or Itemized Deductions - The standard deduction is a fixed dollar amount that is not subject to tax. The value of the standard deduction varies depending on the taxpayer's filing status, and is not based on the size of the taxpayer's family. A taxpayer also has the option to itemize certain deductions, including state and local income and property taxes, mortgage interest, certain medical costs, charitable contributions, and casualty or theft losses. A taxpayer claims either the standard deduction or the itemized deductions, whichever is greater.

Less: Personal & Dependent Exemptions - Taxpayers do not have to pay taxes on a certain fixed amount of money based on the size of their family. These exemptions from income include personal exemptions (for the taxpayer and spouse) and dependent exemptions (for children and other dependents). In 2000, the personal and dependent exemptions equaled $2,800 per person.

Equals: Taxable Income - The amount of a taxpayer's income that is subject to the income tax.

Times: Tax Rates - The Federal income tax has a progressive tax rate schedule, so incremental income amounts (tax brackets) are taxed at progressively higher rates. In 2000, the Federal income tax included five tax brackets with tax rates of 15%, 28%, 31%, 36%, and 39.6%. The income levels defining each tax bracket varies by the filing status of the taxpayer. For example, in 2000, a single taxpayer with $35,000 in taxable income was assessed a 15% tax rate on his or her first $26,250 of taxable income, and 28% on the remaining $8,750 of income. A taxpayer's marginal tax rate refers to the tax rate that applies to the tax bracket in which his or her last dollar of taxable income falls, which for the above single taxpayer would be 28%.

Equals: Tax Liability Before Credits

Less: Tax Credits - Federal tax credits include the earned income, child, dependent care, and adoption credits.

Equals: Individual Income Tax Liability

Other Key Terms:
Filing Status - Each taxpayer filing a return must identify the filing status that is appropriate for his or her. The four filing statuses are single, head of household, married filing a joint return, and married filing a separate return.

Deductions and Credits - Deductions reduce the income that is subject to the income tax and credits directly reduce the tax liability.

APPENDIX B

NEW MARGINAL TAX RATES FEDERAL INDIVIDUAL INCOME TAX					
Married Filing Jointly & Surviving Spouses					
		New Law			
Income Increments[1]:	Old Law 2001	2001-2003	2004-2005	2006-2010	2011 & after
$0 - $12,000	15%	10%	10%	10%	15%
$12,001 - $45,200	15	15	15	15	15
$45,201 - $109,250	28	27	26	25	28
$109,251 - $166,450	31	30	29	28	31
$166,451 - $297,300	36	35	34	33	36
$297,301 & Over	39.6	38.6	37.6	35	39.6
Single Individuals					
		New Law			
Income Increments[1]:	Old Law 2001	2001-2003	2004-2005	2006-2010	2011 & after
$0 - $6,000	15%	10%	10%	10%	15%
$6,001 - $27,050	15	15	15	15	15
$27,051 - $65,550	28	27	26	25	28
$65,551 - $136,750	31	30	29	28	31
$136,750 - $297,300	36	35	34	33	36
$297,301 & Over	39.6	38.6	37.6	35	39.6
Married Filing Separately					
		New Law			
Income Increments[1]:	Old Law 2001	2001-2003	2004-2005	2006-2010	2011 & after
$0 - $6,000	15%	10%	10%	10%	15%
$6,001 - $22,600	15	15	15	15	15
$22,601 - $54,625	28	27	26	25	28
$54,625 - $83,225	31	30	29	28	31
$83,225 - $148,650	36	35	34	33	36
$148,651 & Over	39.6	38.6	37.6	35	39.6
Heads of Households					
		New Law			
Income Increments[1]:	Old Law 2001	2001-2003	2004-2005	2006-2010	2011 & after
$0 - $10,000	15%	10%	10%	10%	15%
$10,001 - $35,150	15	15	15	15	15
$35,151 - $93,600	28	27	26	25	28
$93,601 - $151,600	31	30	29	28	31
$151,601 - $297,300	36	35	34	33	36
$297,301 & Over	39.6	38.6	37.6	35	39.6

1) The income brackets shown for each marginal tax rate are the actual income levels for 2001. As under current law, these income levels will be indexed to inflation each year, except the income levels for the new 10% marginal rate will not change in subsequent years.

Source: Congressional Joint Committee on Taxation and Senate Fiscal Agency.